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FORTUNE

THE LATEST ADVENTURES OF STEVE JOBS

MAKING IT SAFER TO FLY

SEARS ROEBUCK'S STRUGGLING FINANCIAL EMPIRE

LAWYERS FOR COMPANIES IN DEEP TROUBLE

THE DEVELOPER WHO WANTS TO BE A MEDIA MOGUL

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OCTOBER 14, 1985 VOL. 112, NO. 8

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INSURANCE THAT'S NOT SO SURE

Abandoning customary prudence, insurers backed the mortgages of now-collapsed Equity Programs Investment Corp. and are scurrying to cut their losses on huge claims. With insured debt zooming, similar fiascos could nick all sorts of investors. ■ *by Gary Hector*

THE HOTTEST financial product of the 1980s is built on a shaky foundation. Over the past five years, the volume of insured debt—mortgages and securities whose payment is guaranteed by an insurance company or top-rated bank—has exploded. Local governments, financial institutions, and corporations have discovered a powerful new alchemy that lowers interest rates for the borrower, reduces investors' fears, and generates big fees for the insurer. But as investors are finding, the insurance is only as good as the procedures used in screening the risks—which recent events suggest are not good enough.

Disturbing questions about insured debt arose in August when an obscure real estate syndicator, Equity Programs Investment Corp. of Falls Church, Virginia, collapsed and brought down its parent, Community Savings & Loan of Bethesda, Maryland. An EPIC affiliate had sold institutional investors nearly $1.4 billion of mortgages and mortgage-backed securities tied to some of the shakiest real estate imaginable—new homes that builders had been unable to sell.

That didn't faze institutional investors, who snapped up the mortgages because they were insured by a half-dozen of the best-known mortgage insurance companies in the U.S. The investors didn't know that the staid, cool heads at these companies had drifted far from the conservative, low-risk approach they normally follow. On September 5, unable to make mortgage payments, 342 limited partnerships set up by EPIC filed for bankruptcy. Within hours the state of Maryland took over parent Community Savings. Several mortgage insurers, faced with heavy claims, have been scrambling to put together a plan to bail out EPIC.

Investors are left to ask what other disasters may be lurking. The business of guaran-

Gimme Shelter, the Lenders Sing

Nervous lenders are rushing to insure themselves against defaults. The biggest debt insurance market, aside from federal guarantees, is in home mortgages. Coverage has doubled since 1980.

ILLUSTRATION BY JOHN PIRMAN

teeing homeowners' mortgage payments is merely the biggest chunk of the financial insurance market; from the end of 1980 to mid-1985, the total of insured mortgages outstanding doubled to $210 billion. Coming up faster is another business also bruised by EPIC's downfall: insuring securities backed by pools of residential mortgages. In the 4½ years through June, total outstanding securities with this coverage increased 130% to $37 billion.

Other types of financial guarantees, still unscathed, are growing at a breakneck pace. Several companies insure the payment of principal and interest on more than $60 billion in outstanding municipal bonds—ten times the total five years ago. Meanwhile, major banks have backed other muni bonds as well as corporate borrowings with a torrent of standby letters of credit, which provide essentially the same guarantee as credit insurance (FORTUNE, May 13). Since 1980 outstanding letters of credit have tripled to $150 billion.

Innovative financial companies are busily fashioning new guarantees. At least one new firm is getting ready to insure corporate bonds, in theory far riskier than any security yet covered. Investment bankers are searching feverishly for ways to bundle up loans on automobiles, commercial real estate, credit card receivables, or whatever, so they can be insured and sold as asset-backed securities—"securitized" in Wall Street jargon.

BEFORE EPIC'S TROUBLES, mortgage insurance was considered a safe, predictable business. The policies cover fixed- and variable-rate mortgages, generally on owner-occupied, single-family houses, that are not backed by federal agencies such as the Veterans Administration. When a home buyer puts up less than a 20% down payment on a house, banks and other lenders usually insist that an insurer guarantee timely payments. The insurer's fee is paid by the borrower.

Until the past few years, losses were rare. Homeowners hardly ever defaulted on loans, and losses were even lower on insured pools of residential mortgages. With few defaults on mortgage insurance, profits were high and insurers eagerly sought more business. But delinquencies rose with the 1982 recession, just when competitors were starting to hold down premiums in a battle for market share. And insurers diversified into dicier and dicier businesses, such as EPIC's.

STEVE SHAW—WIDE WORLD PHOTOS

Towering insurance claims *face Ticor's Winston Morrow.*

EPIC's operation shouldn't have qualified for mortgage insurance at all. The syndicator's limited partnerships bought unsold houses from builders, mostly in the suburbs of Sunbelt cities. The partnerships borrowed up to 95% of the purchase price of these houses, which EPIC then rented out. The rents didn't cover the mortgage expenses, but EPIC was betting—and said as much in prospectuses that insurers were free to read—that real estate prices would rise enough to produce a profit for the partnerships. To raise cash to make mortgage payments, EPIC kept selling shares in new limited partnerships. It also borrowed heavily from its parent, Community Savings. By the time EPIC announced it could no longer meet payments on all its debt, the company's limited partnerships owned about 20,500 houses, making the syndicator one of the largest owners of single-family dwellings in the country.

An EPIC sister corporation acted as a mortgage banker, arranging its own mortgages, obtaining mortgage insurance, and then selling the loans either directly or as mortgage-backed securities. Buyers included the Federal National Mortgage Association, and such institutions as PSFS, Philadelphia's largest savings bank, and Silverado Banking Savings & Loan in Denver. PSFS, the largest holder of EPIC mortgages, owns about $215 million of its paper. Mortgage insurers could be liable for the first 20% to 25% of potential losses on the EPIC mortgages. Along with legal costs, these could represent claims of as much as $400 million.

Most of EPIC's insurers have the wherewithal to survive the company's collapse. Mortgage Guaranty Insurance Corp. of Milwaukee, the nation's largest mortgage insurance company and a subsidiary of Northwestern Mutual Life, faces just $15 million in potential losses. Republic Mortgage Insurance, with $100 million in exposure, is owned by Chicago-based Old Republic International, a diversified financial company with pockets deep enough to cover any losses. But Ticor Mortgage Insurance Co., a subsidiary of privately owned Ticor of Los Angeles, faces a possible loss of $161 million, two-thirds its capital.

Winston V. Morrow, 61, chief executive of Ticor, which was taken private in 1984 by a group headed by former ITT chairman Harold Geneen, can't explain why the subsidiary took on so much EPIC business. "I'm left with a sense of amazement and fury," he says. "The EPIC involvement is about as far away from what we planned to do as anything you can imagine." What enticed Ticor and other insurers was EPIC's unblemished record of no defaults prior to last summer. Morrow says the industry's excellent record on claims also "led to a general sloppiness" in evaluating new business. In mid-1984, he says, the industry adopted new, tougher standards for writing insurance but went on increasing its EPIC coverage anyway.

In insuring EPIC's debt, the insurers departed from their customary preference for owner-occupied dwellings. They also ignored flaws in the structure of EPIC's partnerships and failed to see that they were a single, related risk. Normally the industry tries to diffuse its exposure over a large number of small risks. Insuring EPIC's mortgages, says a Wall Street investment banker, "is like insuring individual Boeing 747s."

The bankruptcy petition by EPIC's partnerships has let insurers temporarily off the hook, creating new anxieties for lenders. The insurers will not pay claims until they are given clear title to the insured property. With EPIC in bankruptcy, that could take years.

continued

RESEARCH ASSOCIATE *Cynthia Hutton*

Mortgage insurers and lenders who did business with EPIC are vigorously debating ways to bail it out. A detailed plan developed by Ticor has met strong skepticism from lenders. "It was designed, as you'd expect, to benefit Ticor," sniffs a holder of EPIC's mortgages. The central plank of the complex plan calls for lenders to accept a drop in their interest payments to 9% from an average of 13.5%, with the reduced interest made up when the homes are sold. For the next six years, the insurers would pay the lenders only enough to make up the difference between the rental income on the unsold homes and the reduced mortgage payments.

If a bailout plan isn't quickly accepted by lenders, says an executive of a competing insurer, California's insurance commissioner may take over the mortgage subsidiary. Morrow has already fired the subsidiary's key managers and taken steps to isolate it from the company's main business of writing title insurance. He has also ordered Ticor Mortgage to quit writing new insurance policies—a step that by itself may sound the subsidiary's death knell.

Confidence in the mortgage insurance industry is eroding as other insurers scurry to minimize their losses from the EPIC fiasco. United Guaranty Residential Insurance Co. of Iowa, a triple-A-rated insurer, has asked a court to excuse it from claims. The insurer says it's not liable because EPIC misrepresented its financial strength when it applied for coverage; when it learned the true state of affairs, United Guaranty says, it returned all premium checks. If the insurer wins its case, some investors say, they will begin wondering what mortgage insurance is good for. Says a Wall Streeter, "People are going to worry that it is written with invisible ink."

Other investors are nervously watching this turmoil, most notably those who buy insured municipal bonds. This year insurance companies and banks are expected to guarantee payment on a record $50 billion in new issues. So far, municipal bond insurers have virtually untarnished records. They rarely have to cough up because they have played it safe, insuring only borrowers whose debt is already rated as investment quality—a Baa rating or above from Moody's Investors Service or a triple-B from S&P. Insurance entitles these borrowers to higher credit ratings—double- or triple-A—and recently saved them as much as a percentage point in interest expense.

Eager to play, *James Lopp's new company backs corporate debt.*

While the recent loss experience looks terrific, a lot can go wrong during the life of municipal bonds, which may not mature for 30 years. "You have to realize this is a long-term risk," says Roger Taylor, head of product development at Financial Guaranty Insurance Co. of New York City, a leading muni insurer. Right now, he says, his company is being "very cautious."

NOT QUITE as nervous are commercial bankers, who guarantee a wide array of borrowings with standby letters of credit. Bankers generally stick to short- and medium-term debt, and a senior credit officer at Morgan Guaranty Trust Co. says losses have been "much better than on our commercial loan portfolio." But bank regulators worry that standby letters of credit may represent a huge new debt bomb ticking away. Demand is so strong that some banks are turning away borrowers.

Even as some insurers grow more nervous, others are considering new and potentially riskier fare. Insurance of corporate bonds may be the first new product to make its debut. In late July, Financial Security Assurance Corp. opened shop in New York as the first specialized insurer of corporate debt. The risks are daunting. "Cities don't go out of business," says W. James Lopp, chief executive of the new company and founder of the Municipal Bond Insurance Association, the largest municipal bond insurer. "But if a corporation gets in trouble it can file for bankruptcy and disappear." Financial Security, which hopes to sign up its first customer soon, says it plans to be choosy. It will insure only investment-grade notes and bonds and will structure deals that give it first claim on property, accounts receivable, or other liquid assets if things go bad.

No matter how cautious the insurers, financial guarantees all suffer a common weakness. Because the fate of borrowers varies greatly, it's impossible to construct actuarial tables to determine what premiums an insurer should charge to cover potential losses. Says Lopp, "We're not in an actuarial business." To build up reserves against heavy losses, insurers would have to charge stiff rates that would drive away most customers. That's why insurers not only screen risks, but try to start life with a large capital base to provide a cushion. Financial Security has raised nearly $190 million from 15 backers.

Municipal bond insurers face another hazard: complacency. Losses until now have been so small that in a few years the insurers could be tempted to wage a war for market share, complete with the lowered standards that have singed the mortgage insurers. Losses could be disastrous if a major city defaulted on its bonds.

In light of EPIC's problems and growing skittishness on the part of reinsurers, Standard & Poor's is becoming tougher in rating mortgage insurers. It's also fine-tuning an early warning system that determines when municipal bond insurers are committing themselves too heavily to one debt issue. Some insurers, meanwhile, are becoming so picky they may wind up rejecting lots of business. If so, those who peddle risky financial packages, such as securities backed by loans to builders, may find them uninsurable.

Mortgage lenders can be expected to show some pickiness of their own with insurers, preferring those with more capital and a better record of avoiding undue risks. They'll probably direct more of their business to companies unhurt by EPIC's troubles. But that won't eliminate the underlying uncertainties, or the potential for catastrophic losses, when insurers stray from backing safe, predictable products. F

THE STOCK MARKET

The cozy system handed down from Napoleonic times is giving way to American-style trading. London is out front, and is bound to be the big winner. ■ *by Richard I. Kirkland Jr.*

EUROPE'S stock markets are on the brink of revolution, American style. From Milan to Paris to Amsterdam, international competition is forcing brokers and bankers to reform trading methods and break down bureaucratic barriers that in some cases have not changed much since a singularly persuasive regulator named Napoleon shook up Continental bourses in the early 19th century. Some markets are changing rapidly, others more slowly, almost all reluctantly. But none dares stand still.

The big winner is apt to be London. "It's simply naive to think there's any other center in Europe with the breadth, depth, and experience of London," says Michael Altenburg, a Frankfurt-based vice president of Deutsche Bank. The worldwide market will crystallize into three centers, each dominant in its own time zone—New York, London, and Tokyo (see box). If Europe's other exchanges continue to liberalize and modernize, they can become strong regional markets, bearing the same relationship to London as, say, the New Orleans exchange to New York. If they don't, they could travel swiftly from irrelevance to extinction.

Computerized quotes and satellite communications made global markets possible, but the Robespierres of this revolution are U.S. pension funds. Joined by other big institutional investors—in particular British pension and mutual funds—they have been prowling the globe in recent years looking for fresh investments. Since 1980 U.S. pension funds have poured more than $16 billion of their trillion-dollar portfolios into foreign stocks—quintupling their previous overseas stake, according to InterSec Research Corp., a Connecticut-based consulting firm.

Savvy corporate treasurers are learning that by tapping foreign markets they can often raise capital more cheaply and broaden their investor base in the bargain. Some 500 companies are listed on at least one stock exchange outside their home country. A handful of these, such as Imperial Chemical Industries, a British chemical giant, and L.M. Ericsson, a Swedish telecommunications conglomerate, trade more actively abroad than at home. In June, Nestlé, a Swiss food conglomerate, avoided the stock exchanges altogether, issuing $140 million in new shares through the international bank network that handles Eurobonds. "In today's equity markets, borders are becoming irrelevant," says Robert M. Conway, managing director of Goldman Sachs International Corp., the London affiliate of Goldman Sachs, a New York investment banking firm.

For Europe's stock exchanges, the consequences have been both bracing and chilling. Thanks largely to an unprecedented surge of foreign buying, trading volumes and share prices all across Europe have soared to one new high after another. The sole exception to this buoyant turnabout is Greece, where the statist economic policies of the Papandreou government have made its backwater bourse even more so.

But the growing cross-border trading by deep-pocketed foreigners has also exposed numerous flaws in European markets. Says Malcolm Duncan, an official of the Milan Stock Exchange: "Europe's exchanges have been stubbornly attached to their traditional domestic markets and to their private clients. They're late in facing up to the fact that tomorrow's equity markets will be international and dominated by institutions, not individuals." The list of shortcomings is long. Institutions, especially American ones, invest the way Chicago Democrats of Mayor Daley's era voted—in big blocks and often. But outside of London, exchanges typically are open just two hours a day. Prices are not set by continuous processing of individual orders. Instead, buy and sell orders at various prices accumulate before trading begins, and at the opening a price is set that will move the most shares. To buy a big block of stock, an institution may have to pay a fat premium to attract enough sellers—and it may take a pasting when it sells.

continued

RESEARCH ASSOCIATE *Darienne L. Dennis*

No computers *or electronic tote boards track the*

American fund managers are gluttons for information on the stocks they pick. But European accounting practices are often opaque by U.S. standards, and corporations make little effort to keep investors well informed. London's leading brokerage houses produce some first-rate research, but it's rare on the Continent. "The so-called research coming out of places like Switzerland, Holland, Sweden, and Germany is a total joke," gripes a Geneva-based money manager whose firm has a multibillion-dollar portfolio. "It's usually little more than a two-page rehash of a company's annual report."

Above all, U.S. institutional investors expect to pay razor-thin commissions. But ten years after Wall Street eliminated fixed commissions, no Continental exchange has fully embraced the concept. As a result, brokerage costs can be breathtakingly higher in Europe than in the U.S. In an exhaustive study of European stock markets prepared last year for the European Commission, Michael Hall, an official of the London Stock Exchange, and the Milan exchange's Malcolm Duncan compared fees on a $150,000 order. They found that the cheapest price in Europe which happened to be on the Milan exchange in Italy, was 32% higher than the typical U.S. fee, including transaction taxes. The cost in Britain was as much as 300% higher, thanks partly to a stiff 1% government stamp duty.

London is in the vanguard of radical change. Two years ago, as part of the settlement of a seven-year-old antimonopoly suit, the London exchange agreed to abandon fixed commissions. That led to the more sweeping decision to deregulate the entire British market. The authorities realized that, deprived of guaranteed commissions, many undercapitalized London brokers would perish unless they merged with stronger firms. Says Sir Nicholas Goodison, chairman of the London Stock Exchange, "It was obvious that if London was to be a large market for overseas securities, we would either have to allow our members freedom outside the market, or invite the outsiders in."

Under Britain's old system, an otherwise world-class stock market operated as a cottage industry. Merchant banks handled corporate finance and underwrote shares, while so-called jobbing firms monopolized trading and made markets on the exchange floor. Brokers were limited to acting as agents for investors. As a result of this fragmentation, all the various players were woefully undercapitalized by American and Japanese standards. In the new system, which will be operating fully before the end of next year, no competitive holds will be barred. All financial institutions, including foreign and domestic banks, will be allowed to join the stock exchange and engage in the full range of securities transactions. Banks are still denied that privilege in the U.S. and Japan.

In anticipation of this so-called deregulatory Big Bang, British, American, and European banks have been buying up brokerage houses like bargain-crazed tourists at a Harrods summer sale. In little more than a year they have plunked down more than $1 billion for major stakes in 19 of London's top 20 brokers as well as in the three biggest jobbers. U.S. investment banks have stayed out of the shopping spree, but Goldman Sachs, Merrill Lynch, Morgan Stanley, and Dean Witter Reynolds are rapidly expanding their London staffs.

TOTAL MARKET VALUE OF SHARES

BILLIONS OF DOLLARS (est.)

Europe	**$700**
Britain	$302
West Germany	$118
Switzerland	$63
France	$58
Italy	$45
Netherlands	$42
Other	$72
Japan	**$731**
U.S.A.	**$1,783**

SOURCE: CAPITAL INTERNATIONAL PERSPECTIVE, SA, GENEVA, SWITZERLAND

A Three-Cornered World Stock Market

Europe's exchanges are tiny. The value of all shares on the Paris bourse at the start of 1984 was about half the market value of IBM shares on the New York Stock Exchange.

Negotiated commissions will be phased in on the London Stock Exchange sometime next fall. Last year, however, to stanch growing losses of international business to London-based American investment banks, the exchange allowed British brokers to negotiate commissions and make markets on their own account in foreign stocks. Now on a given day, more shares of Germany's BASF, Switzerland's Ciba-Geigy, or France's Source Perrier may trade in London than in Frankfurt, Zurich, or Paris.

Exchanges on the Continent have counterattacked by trimming commissions or permitting big rebates on large orders. Switzerland may soon allow fully negotiated commissions on trades above $825,000. But many Europeans cling to the idea that they can get by with merely lowering rather than unfixing commissions. "We're not interested in negotiated commissions right now because we'd like to retain some profitability," says Voubewign Baron van Ittersum, chairman of the Amsterdam Stock Exchange. But such Canute-like resistance will almost certainly be washed away. Predicts David M. Booher, a vice president with InterSec Research in London: "Three years from now, there won't be a major market in the world that doesn't allow negotiated commissions for institutional buyers."

INTERNATIONAL PRESSURE is also gradually prying the Continental bourses loose from their adherence to collective price setting and limited trading hours. In the past year or so most exchanges have begun letting institutions trade for a few hours before the exchange officially opens. Such "off-market" trading, as it is called, is large and growing. In Paris, for instance, it accounts for 30% to 40% of the exchange's volume. The French, though, have so far refused to abandon their price-fixing system. Off-market trades must be executed at the previous day's price. German banks trading off market can, at the client's request, ignore the officially fixed price and trade at whatever price closes a deal.

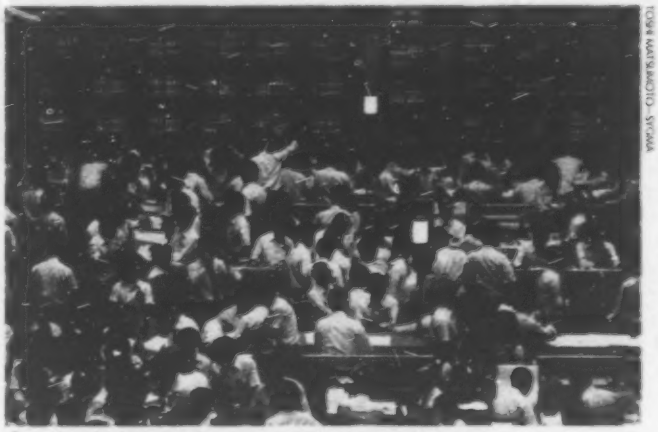
Italy is edging toward continuous pricing. This November the share prices of five major Italian companies with a market value of $6.8 billion—17% of the market value of all companies listed on the Milan exchange—will be allowed to move up and down as orders come in throughout the day. By contrast the Paris bourse, which has been making noises along these lines for six years, won't begin continuous, full-day trading of the most popular French stocks until sometime next year.

The Amsterdam exchange, long one of Europe's most internationally oriented, has decided to stop nibbling at the old system and swallow some big changes whole. In September, official trading in Amsterdam expanded from two hours a day to 6½ hours. At the same time, the exchange began using a new electronic trading system that allows continuous trading of the leading Dutch securities. Such reforms should help blunt London's inroads into the Dutch market and stimulate trading in the 294

THE JAPANESE HAVE REPRODUCED THE BIG BOARD

■ International competition is shaking up the Japanese stock market as much as those in Europe. In April Japan slashed broker commissions by 50% on big-block trades. But the Japanese still regard negotiable commissions as just one more noxious Western import they could happily live without. "It is better for us to have that day come as late as possible," says a Japanese broker. Tokyo's neighbor to the south, however, the much smaller Sydney Stock Exchange, has already taken the plunge. Last year Australia became the first market outside the U.S. to adopt negotiated commissions. With London now poised to deregulate as well, most Japanese brokers privately admit that negotiated commissions are as inevitable as the rising sun.

In many respects, Japanese securities firms and the Tokyo Stock Exchange are in better shape than many of their Continental European counterparts to cope with the challenge of overseas market-makers. Japan's markets operate largely on the American model. Trading hours are long and prices change continuously with the flow of buy and sell orders. The Big Four brokers—Nomura, Daiwa, Nikko, and Yamaichi—are well-capitalized, aggressive sellers, and essentially share the American vision of a future global equity market dominated by a score of giant firms. Like their U.S. counterparts, they also fiercely resist sharing that market with the big Japanese banks, which would like to compete but are prevented by a Japanese version of America's Glass-Steagall Act from participating in the securities business.



TOSHI MATSUMOTO—SYGMA

Trading hours *are long on the Tokyo Stock Exchange.*

Tokyo's market is the second largest in the world, with over $700 billion worth of shares—more than all of Europe combined. Foreign investment now accounts for more than 15% of all trading in Tokyo, a threefold increase in nine years. Over half that money comes from Europe. When they buy foreign securities, Japanese investors prefer bonds, but they are gradually developing a taste for blue-chip overseas stocks, such as Volvo, IBM, General Motors, and British Telecom. In general, foreign shares offer dividends far higher and price-earnings multiples far lower than the paltry 1% dividends and the towering P/Es of 32 times earnings typical in Tokyo. In response, Japanese securities firms are starting to beef up their international research staffs. At Daiwa Securities, eight analysts now follow foreign stocks, up from two a few years ago. "And even that's not enough," says Minoru Mori, Daiwa's international general manager.

Still, Tokyo remains a formidably insular market. Only 14 foreign stocks (including IBM and General Motors) are listed on the Tokyo Stock Exchange, by far the smallest number on any major exchange. Twelve overseas brokerage houses—eight American and four British—enjoy branch status in Japan. But none has won a seat on the exchange, despite a rule change three years ago opening the exchange to foreigners. Merrill Lynch came close last spring. But its $5-million bid for a seat was topped by a $6.6-million offer from a medium-size Hiroshima outfit.

The internationalization of the Tokyo market may be on the verge of a great leap forward. Mori of Daiwa predicts that by year's end seven or eight more foreign stocks will join the Tokyo exchange, now that it no longer requires a formal—and expensive—Japanese audit before granting a listing. American Express and McDonald's, among others, have expressed interest in trading in Tokyo. Officials at the Ministry of Finance and the Tokyo Stock Exchange say that within a month the exchange will raise the ceiling on seats from 83 to more than 90 with the implicit, though unexpressed, purpose of accommodating more foreigners.

The price of admission is likely to be stiff—around $5 million. By contrast, officials at the London Stock Exchange, which will expand from 220 seats to more than 260 when outsiders are admitted next year, expect that joining their club won't cost much more than $500,000. Some Japanese wonder what the foreigners see as so valuable about their humble exchange. Says Hideaki Yamashita, research director at the Tokyo exchange: "From the viewpoint of a cost-benefit analysis, paying so much for a seat doesn't make sense for most foreign securities firms." The foreigners beg to differ. Says Stephen C. Richardson, Tokyo general manager for W.I. Carr, Sons & Co., a British brokerage house: "We want a seat. The returns will be very marginal today, but we're here to stay and we intend to grow."

foreign stocks listed in Amsterdam.

The biggest shock wave won't come from the gradual change in these antique systems but from the emergence of a handful of giant firms that will dominate the underwriting and trading of multinational securities. They'll also be capable of making their own markets to trade foreign stocks outside existing exchanges. "We're going to end up with 12 to 20 global firms, mostly American," says Stanislas M. Yassukovich, chairman of Merrill Lynch Europe and Middle East.

In coping with this prospect, Europe's markets divide into two camps. The Swiss and German exchanges, which are dominated by big banks, and Amsterdam, which allows a mix of bankers and brokers, are about as well armed as they can be. But in the bourses monopolized by brokers—Paris, Belgium, and Spain—the capital shortage is even more acute than the one that previously plagued London.

These markets all function under an arrangement devised by Napoleon more than 175 years ago. Brokers, called *agents de change* in France, are appointed by the Ministry of Finance and given a collective monopoly on all stock market transactions. In exchange for this privilege, brokers face unlimited individual, as well as collective, liabil-

ity. "If you make money the profits are yours. If you lose, everybody shares in your bad luck. So you see why we watch each other very closely," says one young Parisian *agent de change*. To snare institutional business, U.S. investment firms will swallow a big block of stock an institution wants to unload. *Agents de change* aren't permitted by exchange rules to buy on their own accounts. The bourse is considering lifting the restriction, but in any case the *agents de change* don't have enough capital.

THE OBVIOUS WAY to attract capital to the bourse is to let French banks trade securities directly, as they are eager to do. Many observers think the French government will eventually be forced by international competition to permit such deregulation, though the *agents de change* are sure to resist bitterly.

In Germany and Switzerland the big players, such as Deutsche Bank and Union Bank of Switzerland (UBS), have no lack of raw financial muscle. But by their own admission they are hampered by a shortage of skill—at least in their equity operations. To correct that deficiency, they are drawing upon American models. Says Rudolf G. Müller, head of securities sales and trading at UBS: "We're trying to copy the successful U.S. investment banks to a much greater extent." Today UBS has more than 80 securities salesmen, up from a dozen or so ten years ago. UBS, Switzerland's largest bank, and Deutsche Bank have also forged alliances with talent-laden foreign equity houses. Last fall UBS bought 29% of Phillips & Drew, a top London brokerage house with a strong research team, and plans to buy the rest of the firm's shares next year. Deutsche Bank bought a 5% stake in Morgan Grenfell & Co., a leading London merchant bank and the biggest non-U.S.-based manager of American pension fund assets.

The immediate prize the Swiss banks are chasing is the $55 billion held by Swiss pension funds, one of a handful of really sizable European institutional holdings outside London. The Swiss funds have less than 4% of their assets in equities, peanuts by the lights of U.S. funds, which typically invest 50% to 60% of their portfolios in stocks. The Swiss banks are also hoping to defend their prize possession—an estimated $206 billion of private client assets—against steady incursions by British, American, and West German financial behemoths.

By improving their research, the Swiss—and other European equity market players—also may ensure that a large portion of the institutional action in their domestic shares continues to pass through their hands. "With better selling of information, European brokers can offset some of the superior trading skills that U.S., British, and Japanese firms offer institutions," says H. Jörg Graf, director of research at Zurich's Bank J. Vontobel & Co. and one of the few Continental analysts whose reports are closely read rather than routed to the wastebasket. "No one's going to be able to adequately research the top 200 internationally traded stocks by telephone, so research should remain localized."

Europe's smaller exchanges, and the governments that regulate them, need not fear becoming regional markets in London's shadow. If they continue to expand and improve their domestic markets, their overall business can grow even though their international market share shrinks. "My friends on the Continent sometimes express the fear that London is mounting a takeover bid for the European securities business, following the old British imperial tradition," says the London exchange's Goodison. "It is in everyone's interest that the capital market in each country should flourish."

In Italy, for example, the stock market was so moribund a few years ago that it nearly expired. Trading was thin and volatile, dominated by the decisions of a handful of wealthy families. Last year, however, the government finally introduced mutual funds after 15 years of debate. Since then more than $5 billion has flowed into those funds and over $1 billion of that total into Italian stocks.

Propelled by that surge in demand and a big influx of foreign investment, share prices on the Milan exchange have climbed more than 65%, and trading volume has tripled. Some dozen companies have announced plans to issue new equity. Says Roger Hornett, director of European research at James Capel & Co., a leading London broker: "Within a year the Italian Stock Exchange has gone from being a casino attractive only to speculators to a market increasingly dominated by serious institutional money seriously managed."

The changes under way in European stock markets will undoubtedly leave plenty of blood on the floor of the bourses as banks and brokerages merge or go bust. But in the new world of cross-border computerized trading, those markets that fail to adapt will simply be bypassed. Says James Norton, head of the investment division at Morgan Grenfell: "The world's equity markets are gradually going the American way. In the end, that's going to mean more efficient pricing, better information, and better liquidity." For companies that sell stock and investors in Europe the revolution can't come soon enough.

CHRIS STEELE-PERKINS—MAGNUM

Radical change *is the order of the day in London under Chairman Sir Nicholas Goodison.*